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The Manufacturers Hanover Financial Digest

Weekly Commentary, Selected Financial Data, and Business Indicators

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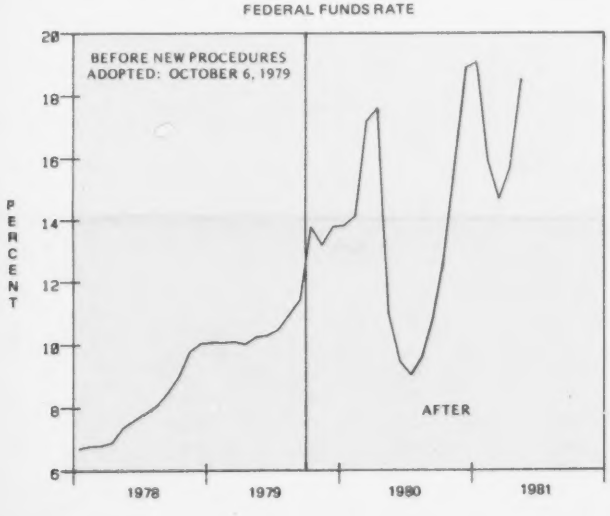
Volatility Plagues Interest Rates . . .

One of the more dubious results of the Federal Reserve's new approach to the conduct of monetary policy has been a pronounced increase in the volatility of both short- and long-term interest rates. With such objectives as orderly financial market conditions and interest rate stability de-emphasized in favor of attempts to control the money supply, wide interest rate swings have not only been permitted, they have become the rule. But whether this approach can provide a suitable backdrop for real economic growth in a low-inflation rate environment remains to be seen. With the real cost of borrowing in the money and bond markets at record high levels, personal and business bankruptcies soaring, the interest rate-sensitive housing and automobile industries flattened (Financial Digest—June 22, 1981) and the outlook for the nation's thrift institutions deteriorating, the burden of proof lies not with the doubters of monetarism, but rather, with its adherents.



Perhaps most indicative of the reduced importance of interest rate stability as the primary policy objective has been the behavior of the Federal funds rate—the price at which banks lend their excess reserves to one another. Whereas this rate had formerly been a principal instrument of monetary policy execution, whose movements were therefore indicative of alterations in the overall thrust of monetary policy, it no longer is, since such rigid control has clearly been de-emphasized. As shown in the chart, the funds rate has gyrated wildly since late 1979.

During the October, 1979-June, 1981 period (the 21-month interval in which the new policy procedures have been in effect), the month-over-month swing in the funds rate averaged approximately 175 basis points, or seven times the size of the average monthly change in this rate during the immediately preceding 21 months. What is more, the month-over-month change in the funds rate was greater than 100 basis points—both up and down—in 12 of the 21 months since October, 1979 and exceeded two full percentage points in seven of the 21 months. Not surprisingly, with most other interest rates influenced directly or indirectly by developments in the funds market, interest rate volatility across the entire maturity spectrum has increased markedly.

Such wide swings as these in the funds rate tend to be a misleading indicator of what the central bank is up to. Currently, for example, the lofty funds rate probably reflects more the stepped-up demand by commercial banks for purchased funds (while at the same time seeking to acquire a larger proportion of short-term liabilities than usual in the expectation of an imminent drop in interest rates) rather than the Fed's tugging on the monetary reins.

. . . Growth In Bank Reserves . . .

With the Federal Reserve unwilling to peg interest rates, thus eliminating much of the significance of fluctuations in such rates, a more useful approach to determining central bank policy intentions would appear to be its willingness to provide nonborrowed reserves—those supplied at the initiative of the Fed through open market operations and now its most direct operating target. But since specific information is only available on a weekly basis, this has prompted some market participants with a need for more up-to-the-minute information to go one step further and carefully monitor the interest rate levels

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prevailing at the time the Fed conducts its reserve draining (dampening rate declines) or adding (dampening rate increases) operations. With this information, relationships between Fed funds intervention points and the intent of monetary policy are then deduced. Any divergence between the presumed intervention points and the rates prevailing when open market operations occur is taken to be indicative of a substantive policy shift.

This approach is, however, misguided. Since the Federal Reserve now attaches more importance to achieving its nonborrowed reserves target rather than a rigid Fed funds rate band, it is quite possible that in order to meet the former target, the latter must be violated. Thus, reserve draining operations can, and do, occur with the funds rate hovering near the upper end of its presumed target band or reserves are added when funds are trading near the lower end of the target band. Put simply, open market operations are no longer undertaken primarily to ensure interest rate stability, but rather to achieve reserve objectives.

Unfortunately, the relationship between reserve growth and the money supply has been somewhat erratic. Over the longer term, of course, the growth of nonborrowed reserves—the building blocks of the money supply—has to be an important determinant of money supply developments. To date, however,

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

	Week Ending 6/17/81	$ Change Since Week Ago	$ Change Since Year Ago
Reserve Bank Credit			
U.S. Gov'ts and Agencies Owned Outright & RPs	129.362	+ 1.744	– .905
Loans to Depository Inst.	1.894	– .312	+ 1.499
Float	3.538	– .109	– .304
Total Reserve Bank Credit	144.556	+ 1.667	+ 4.359
Treasury Deposits with Federal Reserve Banks	3.196	+ .583	+ 1.173
Currency Outside Banks	122.796	– .045	+ 7.667
Member Bank Reserves:			
Required	40.223	+ .961	– 3.045
Excess (Deficiency)	.173	– .076	+ .019
Total Reserves Held	40.396	– .885	– 3.026
Net Borrowed Reserves	1.442	– .238	+ 1.212
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	95.853	– 1.557	+16.104
Monetary Aggregates†		**% Change Since Three Months Ago***	**% Change Since Year Ago**
M-1A	362.0	– 4.0‡	– 1.8‡
M-1B	429.0	+ 4.6‡	+ 10.2‡
M-2 (May '81)	1,741.8	+ 10.9	+ 11.2
L (March '81)	2,428.2	+ 10.6	+ 10.1

†Seasonally adjusted. *Seasonally adjusted annual rate. ‡Four-week moving average.

New York Money Market

Offering Rates 6/26/81	3 Months	6 Months	1 Year
‡U.S. Treasury Bills	14.00%	13.75%	13.00%
* Federal Agencies	14.70	15.26	15.14
* Project Notes—Taxfree (46% Taxable Equivalent)	13.06	13.61	13.06
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market—Prime	17.13	17.35	16.00

‡Finance Company Paper—Prime

5- 14 days	16.00%
15- 29 days	16.50
30- 59 days	16.50
60- 89 days	15.00
90-179 days	14.00
180-239 days	13.00
240-270 days	13.00

‡* Bankers' Acceptances

Jul.	16.85%
Aug.	16.60
Sep.	16.25
Oct.	16.00
Nov.	15.45
Dec.	15.20

‡Industrial Paper—Prime

30- 89 days	16.88%
90-120 days	16.00

†Federal Funds Effective Rate 18.50%

‡Discount basis. * Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	1st Q'81	$ 2,853	$ 2,731	$ 2,572
Gross National Product (1972 Dollars)*	1st Q'81	$ 1,516	$ 1,486	$ 1,502
Percent Change, Annual Rate	1st Q'81	8.6%	3.8%	3.1%
Change in Consumer Prices (all urban consumers)*	May '81n	8.4%	4.8%	10.8%
Change in Producer Prices*	May '81	4.8%	9.6%	6.0%
Civilian Employment (Thousands of Persons)†	May '81	99,235	98,976	97,116
Unemployment as % of Civilian Labor Force†	May '81	7.6%	7.3%	7.6%
Personal Income*	May '81	$ 2,367	$ 2,354	$ 2,114
Leading Indicators Composite Index (1967=100)†	Apr '81	138.3	137.8	126.2
Industrial Production Index (1967=100)†	May '81	152.8	152.3	144.0
Net Change in Consumer Installment Credit†	Apr '81	$ 2.33	$ 3.11	–$ 1.67
U.S. Merchandise Trade Balance†	Apr '81	–$ 2.47	$ 0.49	–$ 1.20
Plant and Equipment Expenditures*	3rd Q'81	$322.88(a)	$317.29(a)	$296.23
Private Housing Starts (Thousands of Units)*	May '81	1,152	1,340	938
New Construction Expenditures*	Apr '81	$ 244.6	$ 251.5	$ 225.8
Total Business Inventories†	Apr '81	$ 474.9	$ 472.4	$ 448.9
Total Business Sales†	Apr '81	$ 346.1	$ 346.6	$ 301.2

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. a-Anticipated.

the growth of nonborrowed reserves has been almost as volatile as interest rates—ranging from a decline of almost 16 per cent at annual rates during the first quarter of 1980, to a more than 30 per cent annual rate of rise during the following quarter (when the real GNP registered its largest quarterly contraction on record). What is more, this "stop-go" policy has persisted: During the almost seven full calendar quarters since third quarter, 1979, the growth of nonborrowed reserves has expanded at double-digit annual rates in three of them, followed in each instance by either a negative growth quarter or much slower expansion, always at an annual rate less than one-half of that posted during the preceding quarter. As a result, and as indicated in the chart on the back page, such instability may have contributed to a similar "stop-go" money supply growth pattern, prompting countervailing policy actions and subsequent interest rate instability.

. . . And The Money Supply

Because abrupt changes in the money supply tend to prompt alterations in central bank policy, the weekly money supply statistics have assumed an importance out of all proportion to their reliability. By juxtaposing the weekly money supply results with quarterly and annual target ranges, conclusions are reached in the money market as to the likely success or failure of monetary policy. But what this

Short Term Paper Outstanding

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
Negotiable Time CD's Weekly Reporting Banks			
Nationwide (6/10/81)	118,950	– 1,686	+24,912
New York City (6/10/81)	27,991	– 372	+ 5,503
Commercial Paper (6/10/81)	145,155	+ 2,233	+20,514

Bank Loans

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
	Commercial and Industrial Loans		
Weekly Reporting Large Commercial Banks			
Nationwide (6/10/81)	176,001	– 622	+18,215
New York City (6/10/81)	51,729	– 420	+ 5,172
	Total Loans Gross Adjusted		
Nationwide (6/10/81)	436,044	– 1,288	+42,436
New York City (6/10/81)	103,449	– 2,322	+14,191

Financial Markets

	Friday 6/26/81	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	14.81%	– .36	+ 7.17
180-Day Bills†	15.06	– .08	+ 7.27
Longest Bills†	14.67	+ .05	+ 6.55
Recent Issues:			
14⅝s 6/30/83	15.56	+ 1.13	
13⅜s 3/31/85	14.36	+ .33	
14½s 5/15/91	13.67	+ .29	
13⅞s 5/15/11	13.12	+ .34	
Municipals:			
Bond Buyer—20 Bond Index* (6/25/81)	10.74%	+ .01	+ 2.98
Blue List Total ($ Million)	$1,890	+$ 791	+ $ 574
30-Day Visible Supply ($ Million)	$1,125	–$1,129	– $ 573
Total	$3,015	–$ 338	+ $ 1
Corporates:			
Moody's Aa Composite (6/25/81)	14.34%	+ .13	+ 3.20
Money Mgr.–30-Day Supply ($ Million)	$7,845	+$ 292	+ $4,150
Stocks:			
Dow-Jones Averages:			
Industrials	992.87	– 3.32	+ 111.04
Transportation	419.37	– .86	+ 143.41
Utilities	108.76	– 1.50	– 5.84
65 Stocks	383.23	– 1.71	+ 64.85
Standard and Poor's 500 Stocks	132.70	+ .73	+ 16.70
N.Y.S.E. Composite Index	76.97	+ .22	+ 10.63
N.Y.S.E. Avg. Daily Vol. for Week (000's)	44,732	– 9,714	+ 5,454

* 46% Taxable equivalent 19.89%.

† Bond equivalent.

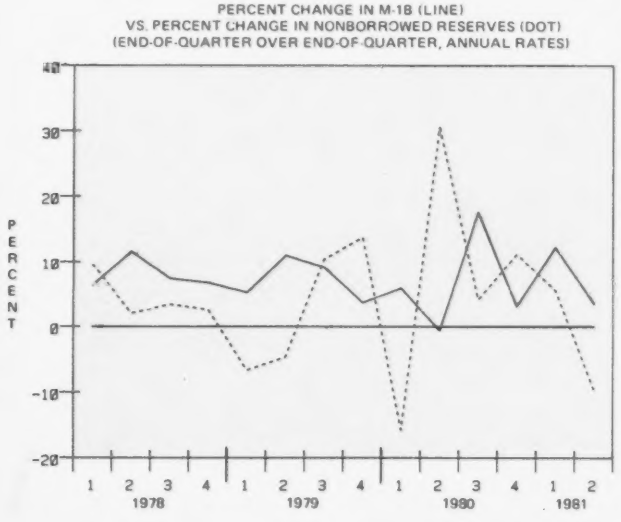
International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 6/26/81	Week Ago
Overnight	19.00%	19.50%
1 month	18.75	19.00
3 month	18.50	18.63
6 month	17.75	17.63
1 year	16.63	16.50
EURODOLLAR BONDS		
Average Yield		
Medium Term (5 to 7 yrs.)	15.10%	14.75%
Long Term (7 to 15 yrs.)	14.85	14.75

FOREIGN EXCHANGE SPOT RATES

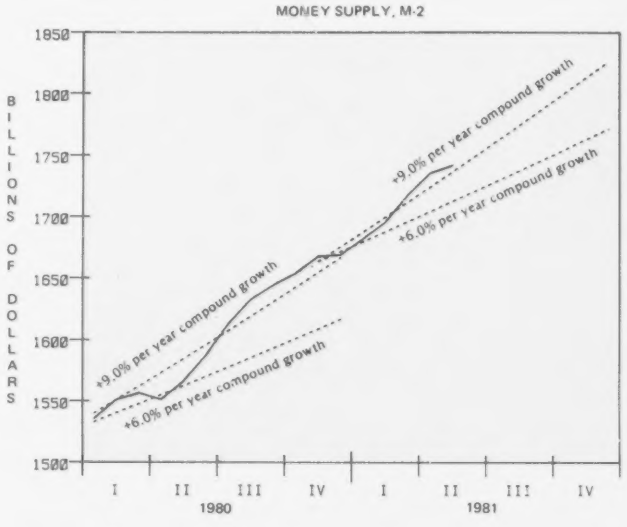
New York Opening (6/26/81)	U.S. $ Equivalent	Currency Per U.S. $
Belgium	.02545	39.29
Canada	.8313	1.2029
Denmark	.1326	7.5400
France	.1738	5.7550
Germany	.4162	2.4025
Italy	.0008354	1197.00
Japan	.004433	225.60
Mexico	.04095	24.42
Netherlands	.3750	2.6665
Switzerland	.4889	2.0455
U.K.	1.9375	.5161

has done is cause people to pay an undue amount of attention to data which are, by and large, statistically unsound. Any weekly number tends to be mostly influenced by random events and contains a lot of statistical noise, and the money supply is no exception. In fact, the Federal Reserve itself estimates that this noise factor could move the money supply up or down by more than $3 billion in any given week.



More important, with the Fed now paying more attention to M-2, undue concern with fluctuations in M-1B could lead to erroneous conclusions as to the likely thrust of future monetary policy. The most recent example: Although the year-to-date expansion of M-1B is now hovering near the lower end of its 1981 target range, monetary policy has not turned more accommodative, much to the disappointment of those who had been expecting sustained money and bond market rallies to result. Although interest rates have declined, the Federal funds rate has remained stubbornly high, reflecting ongoing monetary restraint in an effort to curb the growth of the broader money measure, M-2 (which Federal Reserve spokesmen have been advising bankers and others to watch more closely). During the quarter ending May 31, M-2, ballooned by a surge in the popularity of money market funds, advanced at an 11.4 per cent seasonally adjusted annual rate, placing its year-to-date growth outside the 1981 upper target boundary for M-2 of nine per cent.

Nor is the outlook much clearer. For if the growth of M-2 is to close the year within its specified upper target boundary, it will have to increase by less than $10.2 billion per month during the June-December, 1981 period. This would represent a substantial deceleration from past rates of growth. M-2 increased, on average, by almost $15 billion per month during both the June-December, 1980 period and the first five months of 1981. Thus, it appears quite likely that the central bank will not loosen the monetary reins significantly until M-2 growth returns to its target bands.



The Same Old Story For Federal Finances

Less demand for short-term credit would help slow M-2 growth (or at least the growth of its transactions component), but softer business conditions might not be enough to produce significant declines in interest rates. This is because whatever reduction does occur in private sector credit demands will be replaced by Washington. In recent months, the Federal government's budget outlook has worsened because of a wide variety of factors ranging from the ongoing rise in transfer payments due to inflation, stepped-up defense outlays and the financial burden of servicing an ever-expanding debt (which now stands at almost $1 trillion) at prevailing high interest rates. And if the President's proposals to cut personal taxes and increase defense spending further gain Congressional support, prospects for an early balancing of the Federal budget will decrease even more.

Indicative of the magnitude of the problem was the May budget outcome. Expenditures exceeded revenues by $16.1 billion—about $2 billion more than in May, 1980. This brought the fiscal year-to-date red ink total to almost $64.5 billion, $9 billion higher than the comparable fiscal 1980 period. If the Reagan Administration's official estimate of a $55 billion deficit for the entire fiscal year is to be met, Washington will have to take in more than it spends from June through September. On the other hand, a continuation of the trends of the first eight months would produce a budget deficit for the fiscal year as a whole of almost $70 billion—a new record high.